DEBT BURDEN REDUCTION, LENDING, CONCESSIONAL FINANCE: RELATIVE COST EFFECTIVENESS PERMUTATIONS AND COMBINATIONS

Reginald Herbold Green

On a cloth untrue
With a twisted cue
And elliptical billiard balls.

- Gilbert and Sullivan

1. No simple all country answer as to the appropriate degree of external debt burden writedown (from 0 to 100%) is possible, still less any sweeping pronunciamento on its efficiency *vis-à-vis* lending and/or concessional finance. However, in virtually all cases in which writedown is appropriate it will be as part of a combination of debt writedown, concessional finance and - probably - commercial lending. In that context debt writedown can allow more efficient use of concessional finance, less problematic (to lenders as well as borrowers) undertaking of new commercial loans and a less uncertain climate for external investment.

2. The most appropriate base for evaluating possible writedowns is debt burden: interest plus repayment at present discounted value and the temporal pattern of servicing obligations. Normally the best series to which to relate it is earned foreign exchange (i.e. import/debt service) capacity, i.e. visible and invisible exports (including tourism and worker remittances).

3. No absolute cut-off ratio of debt service burden to earned foreign exchange is appropriate albeit it is reasonable to presume annual flow ratios below 10% are unlikely to justify writedowns and levels above 25% are very likely to do so. The import intensity of the economy, the external finance intensity of investment and the prospects for external earnings are significant in estimating debt service ratios consistent with sustainable growth and development at - say - 6% per annum.

4. One means to estimate needed writedown is to project over 10 years:

a. GDP at 6% compound growth;

b. Import (visible and invisible) levels consistent with "a" on reasonable structural assumptions;

c. Earned foreign exchange (visible and invisible exports plus net remittances) levels - on relatively conservative estimations;

d. External reserve increase requirements (say to 3 months external payments);

e. Net permanent external investment (excluding short term footloose financial capital and probably portfolio investment) computed as new investment less remitted profits plus repatriated capital;

f. Interest and repayment on new loans (commercial or concessional) projected as needed/taken up/received during the decade;

g. With (c + e) - (a + d + f) indicating manageable debt service burden levels on existing external debt stock year by year and for the decade.

This is not a particularly novel approach. It is very similar to that in World Bank evaluations of acceptable/efficiency debt service levels. It does not necessarily imply any impropriety or mutual miscalculation in any or all of the debt incurrance/extension nor, indeed, any philanthropic motives. It is, however, perfectly consistent with globalisation of Adam Smith's basic moral economy premise and imperative that no nation be great and prosperous the majority of whose people were poor and miserable. The bottom line is that global macroeconomic and security (as much as humanitarian) interests are best served by debt service burdens compatible with 6% growth in poor/lower middle income economies and levels significantly above that are *prima facie* candidates for writedown.

5. How a writedown is achieved is a secondary (if doubtless central in negotiating actual packages) issue so long as present value of debt service burden is reduced by an agreed proportion and a practicable time profile for that service achieved:

   a. interest rate reductions, grace periods, extension of repayment period, **additional** concessional finance to service old loans[1] are all acceptable if they achieve (singly or together) the level and pattern needs b different proportions of writedown (by class of credit, by country or institution, by particular characteristics of particular lending transactions) are all acceptable albeit differences among countries (as lenders or homes of commercial sector lenders) and among particular projects/loans are likely to pose severe negotiating difficulties in many cases.[2]

In respect to both "a" and "b" the divergences of interest are basically among lenders - the bottom line for the debtor is total writedown whatever instruments are used and however the cost of those writedowns are divided among creditors.

6. Two contrasting problems arise in respect to debtors who are not servicing (and on reasonable projections can never be expected to service) significant proportions of their external debt and *per contra* those which have never had a substantial writedown, have re-entered the commercial borrowing market but have inefficiently high debt service burdens:

a. in the former case writedowns do not in fact free any present (or in some cases any substantial future) foreign exchange flows. What they do achieve is to create a climate of greater certainty for states, domestic enterprises, external lenders and foreign investors alike by removing a debt overhang which might - at least in theory - come crashing down. In such cases it is clearly inefficient to accept writedowns which reduce present concessional finance inflows significantly or - even in return for substantial writedowns - provide for substantial actual debt service which would not otherwise take place unless the latter is fully or predominately offset by additional concessional or quasi concessional finance. On the face of it, such "dead" debt overhang - e.g. enterprise commercial credit long in arrear and defaulted bank loans/guarantees should be subject to draconic writedowns - not least because enterprises (by above the going rate prices on later cash sales) and banks (by provisioning) usually have written them down or even off.

b. in the latter case special problems of division of writedown burden arise. To seek an across-the-board cut including commercial lenders could prejudice the sustainability of access to new commercial loans. Whether bilateral official lenders would accept making up the whole writedown is problematic. Possibly concessional loans (e.g. by IDA?) to buy back some high interest/short maturity commercial debt plus partial writedown of bilateral loans through retrospective conversion to grants would be practicable.[3]

7. Writedown of World Bank and IMF lendings/facilities is perfectly feasible commercially if desired politically.[4] It can be achieved through at least three modalities (separately or jointly):

   a. *de facto* rolling over short/hard to long/soft facilities, e.g. ESAF for Higher Credit Tranche drawings; IDA credits for World Bank loans - as is being/has been done on a not insubstantial scale;

   b. use of profits from partial sales of gold reserves (IMF) and of a portion of profits (Fund and Bank) for writedowns (albeit in the Bank case this could reduce their use to bolster IDA credit availability);

   c. bilateral funding of a proportion of IMF/World Bank debt service - as already done in respect to arrears in several 'restart' packages (again with a risk of at least partial substitution rather than additionality).

8. The argument that overhang reduction will do little (or negative) good if it simply allows new overhang build-up is valid but - assuming either lender or debtor prudence - is unlikely to apply to very many cases.[5] The cost - especially in Africa - of labouring under excess debt overhangs and the length of the period before temporary relief - let alone substantial writedown - strongly incline prudent governments against new borrowing sprees and the recent historical record should also lead to greater concessional and commercial lender and donor prudence.

9. The argument over debt writedown or concessional finance or commercial lending is misplaced Carteseanism. At least two are likely to be prudent in almost all cases and all three outside a handful of least developed countries with structurally and secularly poor foreign exchange earning prospects. The formula suggested **would** yield 75% to 95% writedowns for a handful of countries, e.g. Mozambique, Tanzania, Guinea-Bissau, Somalia's successor state(s) , but each would self-evidently need continued access to concessional finance even though prudent (for borrower as well as lender) use of commercial finance except via escrow account channelled protected export oriented projects) is likely to be quite limited.

10. In general it is likely to be more efficient to provide writedowns than to increase concessional finance for other purposes and, especially, than to raise commercial borrowing levels. One basic reason is **fungibility**. Tightly constrained finance - as to sources or to uses - is likely to have less impact than unconstrained. Earned foreign exchange freed from debt service is *de facto* (as well as *de jure*) totally untied. A second reason is certainty/predictability. Debt overhang writedown - once achieved - sets new parameters and has a reasonably projectible impact. This cannot be said of (readily reversible) increases in concessional or commercial lending flows. Therefore, it is likely - $ for $ - to have a position impact on public policy efficiency, business expectations and the "animal spirits of entrepreneurs".

11. To stand the previous point on its head and argue that external debt writedown reduces lender/donor leverage and thereby can be expected to reduce efficiency of resource use/quality of public policy could be true but only under rather unrealistic assumptions. These go well beyond borrower imprudence (public and/or private) and/or corruption. (If both borrowers and lenders share these characteristics all resources will be inefficiently used in macro economic or human welfare terms, however sourced and whatever the nominal quasi public conditionalites.) It also requires that the economy after debt service writedowns either requires no capital account inflows or can find adequate footloose financial capital and/or foreign long term investment despite inappropriate policies. The former source can (*vide* Mexico and Pinochet Chile) work for a time but hardly indefinitely and logically can be prevented by IMF-Central Bank action with as well as without writedown. The second is rather unlikely with sound policies let alone with manifestly unsound. As to nil new external capital inflow requirements no low or lower middle income country has exhibited that is a sustained structural characteristic - Botswana did exhibit it for about a decade but appears to be the only case even for that long.

12. However, a caveat is needed. Substitution of actual concessional (let alone commercial) finance for otherwise unmet debt service is **subtractional** rather than additional and efficiency gains are rather unlikely to outweigh immediately usable resource volume losses. Further the usual context in which writedown is seriously discussed is one in which debt overhang and - perhaps - excessive actual debt service are preventing achieving adequate and sustainable growth levels despite substantial concessional finance and are also inhibiting external investment and either extending or accepting commercial loans. In such contexts at least some additionality (plus

writedown of 'dead' debt overhang 'lost' long ago but still on the books) is necessary to achieve any useful outcome.

13. To debate whether debt service burden writedown should be global or case by case is - on the face of it - a confusion:

    a. the formula is (and the principles underlying it are) inherently global or at least poor and lower middle income country wide;

    b. the actual appropriate debt service writedown proportions (or, in practice, range since all ten year projects give more plausible range than point outcomes) will vary because the contexts vary;

    c. the modalities and sharing of writedowns of necessity will be negotiated case by case (preferably in one or two fora) and then embodied in a substantial number of bilateral contracts. However if what is being said is that lenders wish to require detailed case by case conditions - whether economic, political or social - prior to writedown, then the nature of the debate is clear - as is probable opposition to a formula approach to calculating appropriate writedown proportions. Whether removal of debt overhang is a particularly sound Christmas tree to bedeck with semi-related conditionality baubles is problematic but evidently these would be case by case.

14. Therefore, the short answers to whether external debt service burden writedown to appropriate and efficient would appear to be:

    a. in many cases - yes, yes;

    b. with the proportion depending on what historic debt service continuation is compatible with sustainable future growth and development as well as meeting new external obligations;

    c. using whatever writedown modalities and burden sharing[6] are negotiable among creditors in specific cases so long as they add up to the targeted writedown;

    d. and recognising that while writing off 'dead' debt overhang is highly useful for predictability enhancing/expectations improving reasons, it should not be done out of present 'live' concessional flows or one has subtractionality rather than additionality;

e. using a combination of resource availability enhancement routes: debt service burden reduction and concessional finance plus - where appropriate - commercial lending is likely to be superior to one instrument approaches;

f. and recognising that failing to remove debt overhangs is a poor business decision and one quite unnecessary for exerting future leverage or averting future overborrowing.

R. H. Green
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Notes

1. The World Bank's *de facto* policy of refinancing debt service on old Bank loans with new IDA credits for certain SSA borrowers is an example - and one in which the refinancing represents a substantial writedown as do substitution of ESAP for standard IMF drawings. Bilateral cases include Japan, Kuwait and Saudi Arabia.

2. Country differences will arise from differences by category whenever proportions of bilateral official, officially insured and standard commercial lending vary among creditors.

3. Both Zimbabwe - certainly - and the Philippines - probably - are examples of this category.

4. Indeed it is by no means evident that present writedowns of such loans are universally smaller or harder to achieve than for bilateral ones.

5. The plausible scenarios ending in a new debt overhang involve natural (e.g. drought), commercial (e.g. terms of trade) or manmade (e.g. war) catastrophes not foreseen at the time of the writedown. It is hard to see how not writing down would reduce the risk of the first two at all or of the third significantly.

6. This is primarily a lender issue - partly among different states and partly between state and commercial lenders in each state as well as among states.

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